OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ANALYZING THE ANALYSTS:
ARE INVESTORS GETTING UNBIASED RESEARCH FROM WALL STREET?

THURSDAY, JUNE 14, 2001

Mr. Chairman, we meet today to consider the issue of analyst independence, a subject of great significance to our Nation's vibrant capital markets. I congratulate you for your diligence in convening this very important and well-timed hearing.

Over the last several years the perceived immortality of the U.S. economy and the emergence of the Internet have contributed to extraordinary interest and growth in our capital markets. Investors' enhanced access to financial reporting and their newfound ability to trade electronically also helped to fuel this dramatic expansion. Unlike some other sources of investment advice, the vast majority of the general public has usually considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high-tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts' overly optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analyst independence during the Internet craze and affected the quality of their opinions.

We have debated the issues surrounding analyst independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analyst compensation to investment banking activities has become increasingly popular. As competition among brokerage firms for IPOs, mergers, and acquisitions grew, so did the potential for large compensation packages for sell-side analysts. These pay practices, however, may have also affected analyst independence. While some brokerage houses suggest that they have executed an impenetrable "Chinese wall" that divides analyst research from other firm functions like investment banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called into question the actual independence of analysts. A report by First Call, for example, found that less than one percent of 28,000 recommendations issued by brokerage analysts during late 1999 and most of 2000 called for investors to sell stocks in their portfolios. Within the very same timeframe, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6:1 in the early 1990s to 100:1 in 2000. Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division in their brokerage houses. I agree. To me, it appears that we may have obsequious analysts instead of objective analysts.

Today's hearing will help us to better understand the nature of this growing problem and discover what actions might restore the public's trust and investors' confidence in analysts. Like you, Mr. Chairman, I generally favor industry solving its own problems through the use of self-regulation whenever possible. But in this instance, the press, regulators, law enforcement agencies, and spurned investors have also begun their own examinations into these matters. I suspect that these parties may demand even greater reforms than those recently proposed by the Securities Industry Association, including the need for full and robust disclosure of any and all conflicts of interest. To address these concerns, the industry may eventually need to come forward with a way to audit and enforce the best practices it now proposes. If not, others may seek to impose their own solutions to resolve this problem.

We will hear today from eight distinguished witnesses representing a variety of viewpoints. I am, Mr. Chairman, particularly pleased that you invited a representative from the AFL-CIO to join in our discussions. I would have also liked to learn about the concerns of the SEC and NASD, among others. I was, however, heartened to learn yesterday that you plan to hold additional hearings on this issue in the upcoming months with the concerned parties.

As we determined last year during our lengthy deliberations over government-sponsored enterprises, a roundtable discussion is often the most appropriate forum for us to deliberate over complex issues. In the future, I urge you to convene a roundtable over the matters related to analyst independence. A roundtable discussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been scrutinized and sterilized through the clearance process. A roundtable debate would further allow us to more fully educate our Members about the substantive issues involved in this debate.

In closing, Mr. Chairman, I will listen carefully to today's testimony and encourage our Committee to move deliberately and cautiously on these matters in the months ahead. Analyst independence is an issue of the utmost importance for maintaining the efficiency of and fairness in our Nation's capital markets. Finally, given the complex nature of this subject and the controversy surrounding it, I believe that our Committee's deliberations would greatly profit from a roundtable discussion.